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IN THE

Supreme Court of the United States

OCTOBER TERM, 19 .

No. 793

SINCLAIR OIL & GAS COMPANY,

Petitioner,

v.

R. B. MASTERSON, *ET AL.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioner, Sinclair Oil & Gas Company, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above entitled case.

Opinions Below.

The decree of the United States District Court has not been reported, but is shown at page 186 of the printed record on appeal to the Court below. The District Court's

Findings of Fact and Conclusions of Law are shown at page 171 of the printed record on appeal to the Court below.

The opinion of the Court of Appeals (infra, Appendix A, p. 23) is reported at 271 F. 2d 310.

Jurisdiction.

The judgment of the Court of Appeals is dated October 27, 1959 and issued on January 12, 1960 (*infra*, Appendix B, p. 48). A petition for rehearing was denied by order entered on December 21, 1959 (*infra*, Appendix C, p. 49).

The jurisdiction of this Court is invoked under the provisions of 28 U. S. C. A., Section 1254(1).

Questions Presented.

The questions presented cannot be adequately framed without first referring briefly to the decree of the Trial Court, the judgment of the Court of Appeals in affirming the Trial Court, and to a decision of the Supreme Court of Texas.

The decree of the Trial Court requires Petitioner to drill thirty (30) exploratory wells ("exploratory" wells are known and referred to in the oil industry as "wildcat" wells) on the land embraced in the oil and gas leases involved in this proceeding. (R. 205)* The Trial Court dismissed the complaint insofar as it sought a decree for adequate development (R. 208) thereby leaving before the Court of Appeals the question as to the existence in the ordinary oil and gas lease embracing lands in Texas of an

* References marked "R" are to the printed record on appeal to the court below.

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implied covenant to explore for oil (as distinguished from an implied covenant to reasonably develop) regardless of a reasonable expectation of a profit to the lessee. The decree of the Trial Court provides in part as follows:

> "1. Defendant Sinclair Oil & Gas Company, in each year, for five years beginning with the first of the next quarter year after this judgment becomes final, shall drill on the land above described six (6) *exploratory wells* annually." (emphasis ours) (R. 205)

After the Trial Court entered its decree, the Supreme Court of Texas ruled upon the question of the existence under the law of Texas of a separate and distinct implied covenant to explore in connection with the ordinary oil and gas lease and held that no such covenant exists under the laws of the State of Texas. *Clifton* v. *Koontz*, 325 S. W. 2d 684 (Tex. Sup. Ct., 1959). The United States Court of Appeals for the Fifth Circuit, in affirming the Trial Court's decree, failed and refused to apply the law of the State of Texas as declared by its Supreme Court which repudiated the existence of an implied covenant to explore, as set out at pages 696-697 of the *Clifton* case wherein the Texas Court states in part:

> "We hold that there is no implied covenant to explore as distinguished from the implied covenant to conduct additional development after production in paying quantities has been obtained. • • •"
>
> "• • • We decline to follow the theory advanced that there is an implied covenant to explore as distinguished from the implied covenant to develop. There being no implied covenant to explore, the respondents were under no duty to drill a second or additional well, as found by the trial court."

The questions presented by this petition are:

(1) Whether the Court of Appeals erred in failing and refusing to give effect to the law of the State of Texas as declared by its Supreme Court in *Clifton* v. *Koontz, supra,* as decisive of Texas and local law and controlling upon the Court of Appeals with regard to the non-existence in oil and gas leases covering Texas lands of an implied covenant to explore (as distinguished from the implied covenant to reasonably develop).

(2) Whether the law of Texas as declared by the Texas Supreme Court relating to covenants implied in oil and gas leases embracing lands situated in the State of Texas, recognizes the existence of an implied covenant to explore for oil as a separate and distinct implied covenant distinguished from the implied covenant to reasonably develop.

(3) Whether the law of the State of Texas, as declared by the Supreme Court of the State of Texas relating to covenants implied in oil and gas leases embracing lands situated in the State of Texas, recognizes the existence of an implied covenant to explore for oil regardless of a reasonable expectation of profit by the lessee, as a separate and distinct implied covenant as distinguished from the implied covenant to reasonably develop.

Statute Involved.

Title 28, U. S. C. A., Sec. 1652:

> "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply. June 25, 1948, c. 646, 62 Stat. 944."

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Statement.

A. The basic facts.

During the period from 1916 to 1938, Respondents or their predecessors in title, as lessors, executed and delivered to Petitioner or its predecessors in title, as lessee, thirty-one (31) separate oil and gas leases embracing an aggregate of 89,282.86 acres of land in Moore and Potter Counties, Texas, which is a part of the land constituting the Masterson Ranch. This is a large tract of land containing a total of one hundred and forty (140) square miles and is more than twenty miles from the northeastern boundary line to the southwestern boundary line and is about twelve miles from the north line to the south line and about the same distance east and west across the land. Each of the thirty-one (31) leases covered and embraced a separate and distinct tract of land as described therein. By various assignments made by the original lessees, or their successors in title, Petitioner became the owner of the oil and gas leases insofar as the same cover and include the right to produce, sell and market crude oil from the land covered by the leases. The original lessees, or their successors under the aforesaid leases, assigned and conveyed to Colorado Interstate Gas Company, or their predecessors in title, the right under these same leases to produce, market and sell gas from the land covered by the leases (R. 171-174). Each of the leases referred to above contains a primary term and provides that the lease shall remain in full force and effect for the primary term and as long thereafter as oil or gas or either of them is produced from said land by the lessee (R. 184).

In 1938 Respondents or their predecessors in title and Canadian River Gas Company (predecessor in title of Colorado Interstate Gas Company) entered into a "Consolida-

tion Agreement" by which all the leases were consolidated as to gas, and providing that gas produced from the leases as consolidated would keep all of the leases in force and effect (R. 182-184).

Prior to the time this lawsuit was filed, approximately one hundred twenty-five (125) wells had been drilled by Colorado Interstate Gas Company or its predecessors in title, on the land embraced by the aforesaid leases (R. 174) and one hundred fourteen (114) of said wells are productive of large quantities of natural gas and have for many years and every year produced great quantities of gas which have been sold and marketed and the royalties have been paid thereon to the Respondents. From 1939 up to and including the year 1956 there was paid to Respondents as royalties from gas produced and marketed from said land approximately $5,356,848.42, and during the period from 1952 to 1956 inclusive, there was paid to Respondents as royalties on gas produced and marketed from the land covered by the leases approximately $500,000.00 each and every year, and gas is continuing to be produced and marketed in great quantities from said land and royalties paid thereon to Respondents (R. 325).

At the time this suit was filed there was no oil produced either from the lands embraced in the leases or from adjoining lands and the nearest oil production was approximately 15 to 20 miles from the subject land. (R. 403) Most of the acreage covered by the leases lies in the Panhandle Gas Field (R. 405). At the time this suit was filed, any well drilled on the land embraced by the leases would have been an exploratory or "wildcat" well so far as oil is concerned. More than one hundred (100) wells have been drilled on the adjoining property known as the Bivins Ranch, which adjoins Respondents' land on the West, East and South sides, all of which wells (except some dry holes)

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are productive of gas but none is productive of oil in paying quantities.

About the time this suit was filed, Colorado Interstate Gas Company, in drilling a well in the extreme Northwest corner of the subject property, found a show of oil which was the first indication of the possible existence of oil in paying quantities, even though more than 100 wells had theretofore been drilled on the subject land (R. 184).[1] Petitioner, within a reasonable time thereafter, drilled a well in the same quarter section and completed it on November 25, 1955 as a well capable of producing oil in paying quantities. From the time of the discovery of the show of oil in the Colorado Interstate Gas Company well and up to and including the date of judgment of the Trial Court, Petitioner drilled fourteen (14) wells in search of oil on said land of which ten (10) were completed as producers of oil in paying quantities and four (4) were dry holes (R. 176-180). All these wells are located in the Northwest and Northeast portion of the Masterson Ranch wherein the geological structures have been found to be favorable for oil production, except one well which was completed as a dry hole and drilled in the Southwest portion of the Ranch approximately ten or twelve miles from the nearest production of oil on the land in the Northwest portion thereof.

It was alleged in the complaint that, although there had been no technical abandonment of the oil rights under the leases in question, Petitioner had breached an alleged implied covenant to prospect and develop the lands for oil. The Court was requested to enforce the alleged implied cove-

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[1] This was the first indication of the existence of oil in paying quantities. See the trial court's Finding of Fact No. (22), " • • • The existence of oil in paying quantities on the lands involved was not demonstrated until after the filing of this suit • • •" (R. 184).

nant to explore for oil and to give Petitioner an opportunity to select lands on which it desired to explore (or drill wildcat wells) in search of oil, and to require that such leases be surrendered as to lands not so selected.

The amended complaint upon which the case was tried was in all material respects the same as the original complaint except that it alleged that the development and exploration which had been done since the filing of the suit did not constitute adequate prospecting or development at that time. The Trial Court, however, dismissed this portion of the amended complaint (R. 208). Petitioner denied that no effort had been made to explore any of the lands for the discovery and production of oil and asserted that it was then engaged in the diligent exploration and development of those parts of the land on which oil had at that time been found in paying quantities. Petitioner further asserted that the many wells drilled on the land embraced by the leases and on adjacent land constituted exploration for oil on the land embraced in the leases, and in the area of the subject land. Petitioner alleged in its answer that after discovery of oil, Petitioner had commenced and had continued diligently the development of the land for oil, and by reason thereof, denied that it had breached any of the express or implied covenants of the lease.

Upon the trial of the case, Respondents failed to offer any testimony or proof that oil had been discovered in paying quantities upon any part of the land covered by the leases, or that oil had been discovered and produced in paying quantities upon any lands adjacent to or in such close proximity to such lands as to reasonably lead to the conclusion that oil existed in paying quantities or might reasonably be presumed to so exist under the lands in question, except under the immediate area around the oil wells which Petitioner had drilled and was then engaged

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in the development thereof. Respondents also failed to offer any evidence or testimony to show what a reasonable prudent operator would do under the same or similar circumstances.

The trial of of the case was originally closed on June 27, 1957 but a decision was not rendered thereon until more than one year later. By letter dated March 31, 1958 the Trial Judge advised that a further hearing would be held to hear what had been done and "what is in authoritative prospect" since the close of the trial on June 27 of the previous year. (R. 178) In such letter the Trial Court expressed its view as to the existence of an implied covenant to explore:

> "It may be said to counsel now, however, that in my judgment a continued recognition of an implied covenant to conduct exploratory operations on a lease in search of a mineral covered by the lease, but not yet found, is *destined* in the law of Texas, and the usual effect of other production to hold the lease in force will not, in the course of time, impede equitable relief where there has been an unreasonable delay in performing the implied covenant." (R. 178-79) (Emphasis ours)

Pursuant to the above, the trial was reopened and on June 16, 1958 Petitioner submitted evidence and testimony with respect to wells it had drilled since June 27, 1957, together with testimony regarding further plans for development and other exploration (R. 682).

B. The Trial Court's Findings of Fact, Conclusions of Law and Decree.

On September 23, 1958, one year and three months after the trial was originally closed on June 27, 1957, the Trial Court filed its findings of Fact and Conclusions of Law, (R. 171-186), together with its Decree (R. 186-208).

The decree entered by the Trial Court established a schedule of exploratory drilling obligations (drilling of "wildcat" wells) to be conducted by the lessee, requiring the drilling of thirty (30) exploratory wells (even though there were then more than 100 producing gas wells on the property) over a period of five years, and providing for termination of Petitioner's oil rights under the leases (except sections or surveys containing a producing or paying oil well) upon failure to comply with such drilling program, and providing further for certain mandatory and for optional wells, for release of acreage upon the pretermitting of optional wells and for certain penalties (R. 205). As a part of its decree, the Trial Court dismissed so much of the complaint relating to adequate development (as distinguished from exploration) (R. 208).

The Trial Court made no finding of fact as to what a reasonable prudent operator would do under the same or similar circumstances nor was any evidence introduced upon which such finding could be made. Neither was there any finding as to the existence of oil in paying quantities under the lands in question, (except as to the areas in the northeast and northwest corners where Petitioner, subsequent to the filing of this suit, had drilled some oil wells) or in such close proximity thereto as to lead reasonably to the conclusion that oil existed in paying quantities under such lands, nor was there any evidence introduced upon which such a finding could be made.

Petitioner appealed from the Trial Court's decree and contended (among other Specifications of Error not included herein) that the Court erred in holding that there is implied in the oil and gas leases a covenant to exercise reasonable diligence to explore as an absolute duty, without regard to the standards of a prudent operator and without regard to existence of a reasonable expectation of a profit result-

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ing therefrom. After oral argument in the Court of Appeals, the Supreme Court of Texas announced its decision in the case of *Clifton* v. *Koontz, supra,* holding flatly that under the law of the State of Texas, there is no such thing as a separate implied covenant to explore in the absence of reasonable expectation of profit and that such a theory is "untenable and is diametrically opposed to our established 'prudent operator' rule where expectation of profit is an essential element." This expression by the Supreme Court of Texas is particularly important in view of the fact that the decree of the Trial Court in this case dismissed the complaint insofar as it concerned adequate development and limited the decree solely to enforcement of the alleged separate implied covenant to explore which the Trial Court, at the time of its decree, thought to exist in the law of the State of Texas. Because of the decision in the *Clifton* case and the important bearing it had upon the case then under consideration by the Court of Appeals, Petitioner filed a supplemental brief calling it to the attention of the Court.

C. The decision of the United Court of Appeals.

The Court of Appeals for the Fifth Circuit issued its opinion affirming the decree of the District Court.

Basis of Federal Jurisdiction.

Federal jurisdiction in the Court of first instance was based upon diversity of citizenship and amount involved, all as provided for in Title 28, U. S. C. A., Section 1332.

Reasons for Granting the Writ.

By requiring a lessee under an ordinary oil and gas lease to conduct a program of exploratory drilling ("wildcat" drilling) for oil based on the existence of a separate implied covenant of exploration (regardless of a reasonable expectation of profit to the lessee therefrom and in the absence of any showing as to what a reasonable prudent operator would do under the same or similar circumstances), the Court below has decided an important question of private property rights in conflict with applicable Texas law, thereby impairing Petitioner's important property rights in contradiction of the law of the State of Texas, as declared by the Supreme Court of Texas in *Clifton* v. *Koontz, supra.*

Under the law of Texas, unlike the law in some other states, an oil and gas lease creates and conveys to the lessee a determinable fee in the oil and gas in place and is an interest in real property. Such property right is the basic building block of the oil and gas producing industry and might be characterized as the stock in trade of that industry. The issue with which we are confronted here goes to the core of the important property right created by an oil and gas lease and affects the entire oil and gas producing industry in Texas.

The refusal of the Court of Appeals to apply and follow the substantive law of Texas to the question involved creates a favored forum in the Federal courts wherein lessors, (meeting jurisdictional requirements) seeking to enforce alleged implied covenants not recognized in Texas law, will seek to have their complaints adjudicated. It would result in the creation of one substantive law in non-

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federal matters, for those favored plaintiffs who were in a position to have their complaints heard in Federal Courts by reason of diversity of citizenship and still another system of substantive law for those who would be compelled to seek their remedy in state courts. It was this very result that Congress sought to avoid when it enacted the Rules of Decision Act,[2] and by the United States Supreme Court in its decisions in *Erie Railroad Co.* v. *Tompkins,* 304 U. S. 64, 58 S. Ct. 817, 82 L. Ed. 1188, and *Guaranty Trust Company* v. *York,* 326 U. S. 99, 89 L. Ed. 2079, 65 S. Ct. 1464. There should be no difference in the principles of law to be applied regarding the covenants of oil and gas leases merely because there is a diversity of citizenship permitting a case to be tried in the United States District Court while in another and similar case, it would be tried in the State Court because there is no diversity of citizenship or jurisdictional amount, for after all, under diversity jurisdiction in non-federal matters, the United States District Court is a trial court sitting in Texas to try cases and apply the law as defined by the statutes and Courts of the State of Texas. Unquestionably under this decision of the Court of Appeals there will be a diversity of principles as between cases of this sort tried in the State and the Federal Courts. The Texas District Courts are bound to follow the Supreme Court of Texas in the *Clifton* case.

This is not a case involving only private property rights nor is it a case which will sink into oblivion when the decision is finally made, but it is a case of extreme importance as a precedent for the guidance of the bench, the bar and the public in future litigation. The oil industry is of paramount private interest and public concern in the State of Texas and in that State there are areas of large land hold-

[2] 28 U. S. C. A., Sec. 1652.

ings as well as small holdings embraced by oil and gas leases covering millions of acres. In this situation a more important precedent can hardly be imagined than will result from the decision made in this case.

This Honorable Court should grant this Petition for a Writ of Certiorari and correct the opinion of the Court of Appeals as an impediment of the universal application in Courts sitting in Texas of the principles of law as so firmly established by the Supreme Court of Texas in the case of *Clifton* v. *Koontz, supra.*

Argument.

As heretofore shown, this action was instituted in the Federal Court based on diversity of citizenship. Inasmuch as the subject matter of the litigation concerned the construction of oil and gas leases covering lands situated in the State of Texas, and the rights and duties of the lessor and lessee thereunder, it must be determined in accordance with the law of the State of Texas as declared by the Supreme Court of Texas, pursuant to the doctrine of *Erie Railroad Co.* v. *Tompkins, supra,* and *Guaranty Trust Company* v. *York, supra.*

It is important to a proper determination of the instant case to keep in the forefront the reasoning employed by the Trial Court as the basis for a decree requiring the drilling of exploratory wells without evidence or a finding that such exploratory drilling could reasonably be anticipated to result in a profit to the lessee. In this connection the Trial Court's reasoning, although erroneous, is made very clear by its Conclusion of Law No. 7, which reads:

> "Under the facts of this case, no burden rests on plaintiffs to show that the drilling of any or all of

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such exploratory wells would result in profit to the defendant" (R. 186).[3]

In the instant case it should be noted that, although that part of the complaint dealing with the implied covenant to reasonably develop was dismissed by the Trial Court leaving only the question of the existence of a separate implied covenant to explore, the Court of Appeals apparently ignored this important fact and, in its opinion, referred to the question before the Court as being one of "exploration-development".

That Respondents' theory of the case, which was sustained by the courts below, is clearly inconsistent with the laws of Texas, is evidenced by the allegations contained in Paragraph XI of the Amended Complaint, (R. 32) wherein it is alleged that an ordinary prudent operator would have drilled to deeper formations to determine whether or not they might be productive even though it was admitted in the same sentence that "such deeper formations are 'wildcat' in nature and little is known as to their characteristics in the area in which Respondents' lands are located * * *"

The decree of the Trial Court (which was affirmed by the Court of Appeals) requires the drilling of a stated num-

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[3] Compare this with the Texas Supreme Court's expression at Page 695 of its opinion in the *Clifton* case (Supra) where the court said: "This Court in the case of *Texas Pacific Coal & Oil Co.* v. *Barker*, supra (117 Tex. 418, 6 S. W. 2d 1036), quoted with approval the holding in the case of *Brewster* v. *Lanyon Zinc Co.*, supra, wherein the Court said: 'The large expense incident to the work of exploration and development, and the fact that the lessee must bear the loss if the operations are not successful, require that he proceed with due regard to his own interests, as well as those of the lessor. No obligation rests on him to carry the operations beyond the point where they will be profitable to him, even if some benefit to the lessor will result from them. It is only to the end that the oil and gas shall be extracted with benefit or profit to both that reasonable diligence is required.'"

ber of exploratory (wildcat) wells. The distinction between exploratory (wildcat) wells and development wells is that development wells are drilled with reasonable expectation of profit after the presence of oil or gas in paying quantities has been demonstrated to exist, either on the lands concerned or in close proximity thereto, whereas exploratory wells are a highly speculative undertaking resulting in an extremely high loss ratio because of the large proportion of dry holes encountered. What concerns us here is the fact that the Federal Court (contrary to Texas law) has concluded that there is implied in oil and gas leases a separate and distinct covenant to explore, regardless of a reasonable expectation of profit and in complete disregard of what a reasonable prudent operator would do under the same or similar circumstances. In affirming the decree of the Trial Court, the Court of Appeals brushed aside the principle of law declared to be the law of Texas by its Supreme Court in the *Clifton* case, *supra*. In that case the Texas Supreme Court had before it the very question involved here, as well as the question of reasonable development, and it was necessary for the Court to separately dispose of each of such questions.

In refusing to follow the rule announced in the *Clifton* case the Court of Appeals characterized the Texas Supreme Court's language as being "quite general" and, therefore, limited to the facts before the Court,[4] even though the Supreme Court, in speaking of an implied covenant to explore at Page 697 of its opinion said:

> "• • • This theory is untenable and is diametrically opposed to our established 'prudent operator' rule where expectation of profit is an essential element. See *Texas Pacific Coal & Oil Co.* v. *Barker, supra*.[5] We

[4] Appendix A, P. 33, *infra*.

[5] 6 S. W. 2d 1031; 60 A.L.R. 936.

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> declined to follow the theory advanced that there is an implied covenant to explore as distinguished from the implied covenant to develop. There being no implied covenant to explore, the respondents were under no duty to drill a second or additional well, as found by the trial court."

As a further example of what clearly appears to be a misconception by the Court of Appeals as to the holding and effect of the Supreme Court of Texas in the *Clifton* case, we quote from the opinion of the Court of Appeals, as follows:

> "All that the Supreme Court of Texas did there was to affirm the findings of the trial court against the contention that the undeveloped 320 acres would probably produce oil, and that no profit to lessor or lessee would accompany the bringing in of other gas wells under the regulations of the Texas Railroad Commission."[6]

And further:

> "It approved the finding of the trial court that under the facts and the terms of the lease, there was no duty to conduct further exploration."[7]

Such statements, of course, clearly indicate that the Court of Appeals was mistaken as to the decision of the Court in the case and refused to follow the law as declared by the Supreme Court of Texas. The Supreme Court of Texas did not approve the findings of the Trial Court since the Trial Court had, in fact, required exploratory drilling. What the Supreme Court did was to affirm the opinion of the Court of Civil Appeals which had already reversed the judgment of the Trial Court.

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[6] Appendix A, P. 39, *infra*.

[7] Appendix A, P. 33, *infra*.

In support of its characterization of the language of the Texas Supreme Court in the *Clifton* case as "general", the Court of Appeals made reference to a paragraph out of the opinion, to-wit:

> "However, it should be noted that we do not have a factual situation where the lease covers several thousand acres and an effort is being made to hold such vast acreage by showing production from a comparatively small area. Neither are we confronted with a situation where an unreasonably long length of time has elapsed since the last development of the leased premises. Therefore, we do not pass upon these questions."

as to which the Court of Appeals said that such language could not have furnished a surer guide for the interpretation of the opinion if it had been used with the Masterson decree in mind. The paragraph referred to is quoted, not because it has anything to do with the question of exploration, but because of the importance attached to it by the Court of Appeals. An examination of the Supreme Court's opinion in the *Clifton* case, when taken in its proper context, clearly shows that the paragraph quoted above relates only to that portion of the opinion dealing with the covenant for reasonable development and even in that connection is nothing more than dictum. From this springboard, the Court of Appeals then embarked on a discussion of a case decided by the United States Court of Appeals for the Eighth Circuit in *Brewster* v. *Lanyon Zinc Co.*, 140 F. 801 (8 Cir. 1905) and another by the Tenth Circuit in *Sauder* v. *Mid-Continent Petroleum Corp.*, 292 U. S. 272, 54 S. Ct. 671, 78 L. Ed 1255 (1934). In its opinion, the Court of Appeals apparently placed great reliance upon these cases as supporting its view, because they were cited

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by the Supreme Court of Texas in the *Clifton* case. It is true that they were cited, however, not for the proposition announced by the Court of Appeals in this case, but to the contrary, were stated to have no application to the alleged implied covenant to explore, because they dealt solely with the development covenant rather than the covenant of exploration. The *Brewster* and *Sauder* cases did not purport to pass upon the law of the State of Texas relating to implied covenants to explore. To clear up this point, it is worth while to quote the pertinent language appearing at Page 696 of the opinion of the Court in the *Clifton* case with respect to the *Sauder* and *Brewster* cases, as follows:

> "The Court of Civil Appeals in the *Willingham* case, *supra,* cites the case of *Sauder* v. *Mid-Continent Petroleum Corporation,* 292 U. S. 272, 54 S. Ct. 671, 78 L. Ed. 1255, 93 A. L. R. 454, in support of its theory of the existence of a covenant to explore. However, the court in the *Willingham* case makes no reference to the clearly stated issue in the *Sauder* case. 292 U. S. at page 278, 54 St. Ct. at page 672.
>
> > 'The question for decision is whether the respondent failed to comply with an implied covenant to develop the tract with reasonable diligence.'
>
> "The court did not treat exploration as a separate covenant, but instead followed the basic theory in the case of *Brewster* v. *Lanyon, supra.* The latter case dealt solely with the development covenant. In addition, the court in the *Sauder* case, justifies its holding upon the peculiar circumstances surrounding the drilling on the disputed lease where drilling had been so long delayed."

From the foregoing, it is abundantly clear that the Texas Court did not consider either the *Sauder* or the *Brewster* cases to be authoritative with regard to an implied covenant

to explore. The Court in the *Clifton* case (P. 696), in speaking of the existence under the law of the State of Texas of the implied covenant to explore said:

> "We hold that there is no implied covenant to explore as distinguished from the implied covenant to conduct additional development after production in paying quantities has been obtained. Petitioners argue that the lease involved expressly provides for exploration. We agree that, under the terms of the lease, the lessee has the right to explore, but it does not necssarily follow that the lessee is under a duty to explore. To follow petitioners' argument would be to adopt the theory advanced in their 'Outline of Argument', filed in this Court, that 'In an oil and gas lease, the implied covenant reasonably to explore obligates the lessee to drill when a ready, able and willing operator would drill regardless of the certainty of profit.' In support of this theory the petitioners cite the case of *Willingham* v. *Bryson*, supra, and Meyers, 'The Implied Covenant of Further Exploration', 34 Tex. Law Rev. 553. This theory is untenable and is diametrically opposed to our established 'prudent operator' rule where expectation of profit is an essential element. See *Texas Pacific Coal & Oil Co.* v. *Barker*, supra. We decline to follow the theory advanced that there is an implied covenant to explore as distinguished from the implied covenant to develop. There being no implied covenant to explore, the respondents were under no duty to drill a second or additional well, as found by the trial court."

The Texas Court in denying the separate existence of the implied covenant to explore, also stated at Page 696 of its opinion:

> "Our examination of the Texas cases reveals that the corpus of the oil and gas law, as it has developed,

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> treats the covenant of development as covering all additional drilling requirements after production is once obtained on the lease, except those for protection from off-set wells which are draining the premises."

The foregoing is the pertinent language of the Texas Supreme Court which the Court of Appeals, in the instant case, characterized as "general" and, therefore, not controlling in this case. The Court of Appeals, under the guise of agreeing with the decision of the Texas Court in the *Clifton* case has in fact emasculated it by a strained construction of the *Clifton* opinion as applicable only to a small tract of land, as if to say that one solution of the question whether an implied covenant to explore exists under an oil and gas lease, is applicable to a lease covering X number of acres, another solution to one covering Y number of acres; and that the implied covenant to explore applies to a big lease but not to a little one. How big is enough to spring an implied covenant to explore into being? How little is enough to extinguish it, if the principle is to be decided on size alone?

We respectfully submit that there is nothing "general", or outside the case, in the language of the Supreme Court of Texas in its opinion in the *Clifton* case concerning the non-existence of an implied covenant to explore, but to the contrary, we can conceive of no more forceful language which could have been used in repudiating the existence of a separate and distinct implied covenant to explore.

The Texas Supreme Court's forceful denial of the separate existence of an implied covenant to explore must be held to be controlling upon the Federal Court as expressive of the Texas substantive law until such time as the Supreme Court of Texas sees fit to repudiate or overrule its decision in the case.

Conclusion.

For these reasons, it is respectfully requested that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in this case, and that said judgment be reversed by this Honorable Court and that your Petitioner may have such further relief as this Honorable Court may deem just, proper and equitable.

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APPENDIX A

IN THE

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT.

No. 17530

SINCLAIR OIL & GAS COMPANY

Appellant,

versus

R. B. MASTERSON, *et al*,

Appellees.

Appeal from the United States District Court for the Northern District of Texas.

(October 27, 1959.)

Before RIVES, Chief Judge, and CAMERON and JONES, Circuit Judges.

CAMERON, Circuit Judge: Sitting without a jury, the court below entered a judgment in favor of plaintiffs Masterson, appellees here, and against defendant Sinclair Oil & Gas Company, appellant here, requiring Sinclair to drill within the ensuing five years thirty exploratory wells prospecting for oil, providing alternatively for the surrender of lease acreage or payment of money penalties. The Mastersons own ninety thousand acres[1] of land in Moore and Potter Counties, Texas, and had, between the years

[1] The correct number is 89,282.86 acres, but we will follow the lead of the litigants and refer to the acreage in round numbers.

1916 and 1938, executed thirty-one separate oil and gas leases. By mesne assignments these leases, insofar as they covered oil, had come into the ownership of Sinclair, and the gas rights had become the property of Colorado Interstate Gas Company.[2] Colorado, or its predecessors in title, had adequately explored and developed the leases as applied to gas by drilling 114 wells, and had by contract with the Mastersons been released from further obligation to drill for gas.

From the decree entered against it Sinclair appeals, specifying sixteen errors which it relies upon for reversal and which it reduces to eight principal issues. In summary, its main contentions for reversal are these:

That Sinclair was under no implied covenant to "explore" the Masterson lands for oil (as differentiated from the implied covenant to develop), because Colorado and its predecessors had extinguished the obligation to explore by drilling the 114 wells, this contention being based upon the claim that such covenants were not divisible as between the owner of gas rights and the owner of oil rights, and that Sinclair was entitled to credit for all of the exploration conducted by Colorado and its predecessors; that Colorado's explorations and the wells drilled by Sinclair after the filing of this civil action had satisfied Sinclair's duty to explore, it being contended that under Texas law, there was no implied duty to explore after the Masterson leases had been proven by these gas and oil wells; that the sole obligation then resting upon Sinclair was to "develop," which obligation did not arise without proof on the part of the Mastersons that the drilling of exploratory wells would probably result in a profit to Sinclair; that the decree of the court below is arbitrary and is unsupported by any evidence which would justify the exploration or the alternative penalties required by the judgment; that as to three of the leases, the presence of express covenants negated the existence of any implied

[2] The court had, of its own motion, brought Colorado in as a defendant, but it was eliminated from the case by the final judgment and is not a party to this appeal.

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covenants; that as to one lease, a prior suit brought by the Mastersons was *res judicata* of the present action; and that the judgment of the court below was too ambiguous, uncertain and indefinite to furnish an enforceable guide or standard of what Sinclair was required to do.

The validity of these several points must be tested under the legal principles for which Sinclair contends as applied to the facts as found by the trial court. These facts will be brought into as narrow compass as their complexity will permit.

This civil action was brought June 16, 1955 "to enforce the implied covenant or covenants, alleged to exist in and as a part of each of such leases, for adequate exploration and development of the lands covered by such leases insofar as oil is concerned." The ninety thousand acres of the Masterson ranch were covered by thirty-one leases given to various individuals largely during the period 1916 to 1924 and all prior to 1940. Each of the leases was executed for a small bonus consideration averaging less than $1.00 per acre; the primary terms were short, running from one to four years in most instances. Each lease contained a provision requiring the payment of royalties measured by the quantities of oil produced and a provision requiring the payment of royalty measured by the volumes of gas produced.

By writings executed mostly in 1928 and all prior to 1940, the oil rights and the gas rights under the leases were partitioned, and have, during the intervening period, been held by different producers. This partition was accomplished by conveyances between the different lessees and their assigns, except as to one set of leases covering 1,260.67 acres in which the Mastersons partitioned the oil and gas by separate leases to those owning the respective rights in the other lands. In 1928, the owners of the oil rights and the owners of the gas rights entered into an operating agreement containing, as one of its terms, an option to the owner of the respective oil and gas rights to take over, under the provisions of the agreement, any well

which either might sink which encountered the mineral owned by the other.

Prior to the filing of this action, 114 wells had been drilled on the Masterson lands by the owner of the gas rights and for the production of gas only, eleven of which were dry holes. A few of these gas wells had been drilled to a depth sufficient to test the oil horizon, and some of the drilled wells had revealed oil "shows." If oil exists at any point on the Masterson lands, "the better prospect will be to find it at horizons below those from which the gas lessee had been producing gas, and it was not the practice of the gas lessee to drill its well a sufficient depth to test such oil zone." The zone at which oil, if any, may be expected to be found in most of the area is from approximately 200 feet above to approximately 100 feet below sea level. Of the 114 wells producing gas from the Masterson lands, only two have been drilled to sea level, and only five have been drilled into the horizon from 200 feet to sea level, two of which encountered oil shows.

The owner of gas rights had fully explored and developed the leased premises for gas, but after the separation of oil and gas rights and prior to the institution of this action, no owner of the oil rights had drilled a well on the Masterson land. Commencing in June, 1954, plaintiffs commenced negotiation with Sinclair seeking *development* by it of the oil rights conveyed in the leases. These negotiations terminated when, May 19, 1955, Sinclair stated that "it had reviewed all facts available with regard to development on the lands, had studied geological opinion on those facts, and had reached the conclusion that there had been no default by it in the conduct of exploratory operations on the Masterson lands." This letter precipitated the filing of this action. The complaint does not challenge that the leases are in full force and effect as to both oil and gas, but seeks "an enforcement of the leases by a determination that defendant has violated the implied covenants of the leases requiring the exercise of reasonable diligence in prospecting and developing for oil the leases on plaintiffs' lands, and that defendant be required to proceed with

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operations under such a program and within such a time as the Court shall find equitable."

Sinclair commenced its first drilling of a well on plaintiffs' lands about three months after this action was begun, choosing to drill at a point where Colorado had encountered oil in deepening one of its gas wells. This Sinclair well was completed as an oil producer Nov. 25, 1955. Prior to the first hearing of this action in June, 1957, Sinclair commenced the drilling of seven other wells, of which five were completed as producers of oil and two as non-producers. All of these wells were in the section in which the discovery well was located except one, which was in the section immediately to the east. All of the wells were in the northwest corner of the Masterson land except one, which was located about ten miles east of the others and near the northeast corner of plaintiffs' land. Over a period of two years from the filing of the suit and three years from the time of plaintiffs' demand, defendant had drilled upon the Masterson 90,000 acres only eight wells, six of which were producers and seven of which were in a limited area.

At the first hearing in June, 1957, a subordinate official of Sinclair predicted considerable activity and drilling by defendant in the immediate future, which included also seismograph explorations on the entire Masterson tract aimed at determining the best places to drill. He predicted that the seismograph work would be completed by the middle of August and that this would reveal what oil deposits probably underlay these lands.

After studying briefs furnished by the parties, the court below addressed a letter to them expressing the opinion that the defendant had been guilty of unreasonable delay in performing the implied covenant to explore for oil, manifesting no interest in oil exploration on these lands for a very long period of time. It expressed the opinion also that the wells which had been drilled for gas were inadequate to test for oil. The court stated that it found the testimony of the likelihood of finding oil under the vast reaches of the Masterson lands in conflict, and that it felt that it ought to await the seismograph survey and

the further actions of Sinclair towards performance of the lease provisions before completing the hearing.

When the hearing was resumed about a year later, the court discovered that only three additional wells had been drilled, mostly in the general neighborhood of the discovery well, two of which were good producers, and that arrangements had been made for drilling four more wells, one of which was completed in June, 1958 as a prolific producer. At the reopened hearing, the court found that the wells drilled in the intervening period were still inadequate, that the seismograph work had not been prosecuted as promised, that no top policy man testified that adequate development was in authoritative prospect.

The court found that "The evidence shows that it is fairly probable that some of the undeveloped areas of the leased land will be found to be productive of oil, but the number and extent of such areas can be determined only by drilling;" that Sinclair had been neglectful of the rights of plaintiffs, that development both before and after the filing of this action had been inadequate, that the zone where oil would be most likely to be found had not been penetrated by the gas wells, and that particularly in view of the enormous acreage involved and of the unusually long delay in drilling, the plaintiffs were entitled to the relief they sought.

The judgment entered was based upon its conclusions of law that each of the leases required the exercise of reasonable diligence on the part of the oil lessee adequately to explore and adequately to develop the leased premises, and that the duties resting upon the oil lessee and those upon the gas lessee were separate and distinct with respect to such exploration and development; that the separation of the oil rights and obligations from those pertaining to gas was legal, and that the obligations resting upon Sinclair were independent of those resting upon Colorado; that it was not equitable that Sinclair be required to explore each lease separately, as normally it would be obliged to do, but that the entire 90,000 acres should be considered as if under one lease for the purposes of minimum require-

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ments of drilling for oil; and that "Under the facts of this case, no burden rests on plaintiff to show that the drilling of any or all such exploratory wells would result in profit to the defendant."

Based upon its findings and conclusions, the court, as stated, ordered Sinclair to drill six exploratory wells annually for five years so spaced as to reflect a good faith effort to make a fair search in different areas for oil production, to be drilled to the horizons the court had found to be those where oil would be found if any should be present. Failure of defendant to show its good faith by completing the wells required in the first year would result in cancellation of the leases except as to the sections or surveys wherein producing and paying oil wells were located. After the first year, defendant could be excused from drilling any well by surrendering three thousand acres of its own choosing or paying $50,000.00, shown by the proof to be about the cost of drilling a well. The surrender of acreage in the second and third years is increased to five thousand to be selected by plaintiffs if defendant fails to comply with the terms of the judgment. The judgment left untouched the obligation of Sinclair to develop proven portions of the tract, and plaintiffs' action was dismissed as far as it related to any obligation on Sinclair's part to drill to formations below those described therein.

Sinclair first attacks the judgment entered by the court below and its findings and conclusions on the ground that they are in conflict with a decision rendered by the Supreme Court of Texas since this case was tried in the court below and since it was argued before us, it being discussed in supplemental brief by both parties.[3] Its contention is based chiefly upon the claim that the Mastersons were not entitled to any of the relief they sought, because under the *Clifton* case it should be held as a matter of law that the evidence before the court below was insufficient to support its find-

[3] *Clifton et al* v. *Koontz*, S. Ct. Tex. 1959, 325 S. W. 2d 684, affirming the decision of the Court of Civil Appeals of Texas, Fort Worth Division, 1957, 305 S. W. 2d 782.

ings and conclusions in that plaintiffs failed to sustain the burden of proving that further exploration or development would result in a profit to the lessee. The importance attached to this decision by appellant warrants a close examination of what was held and the factual basis of the holding.

Mrs. Clifton sued to cancel an oil, gas and mineral lease upon approximately 350 acres[4] upon which one well had been drilled which produced gas and a small amount of oil and which was classified under the rules and regulations of the Texas Railroad Commission as an "associated" gas well. In the course of the years the leasehold estate had been broken up into fractional interests and Koontz acquired a considered portion thereof. He procured the classification of the well to be changed so as to increase the amount of the "allowable" production and began, about Sept. 12, 1956, reworking the well with such success that within a few weeks, the production of gas from the well had been increased about eighteen hundred times.

In August, 1956, Mrs. Clifton had sued Koontz and several other fractional leaseholders seeking cancellation of the lease, based chiefly upon the assertion that a Mr. Kadane had drilled a well on adjoining acreage and had obtained a good oil showing, and had contracted with Mrs. Clifton that, if she could succeed in cancelling the lease to Koontz and others in whole or in part, he would take over that released and drill a well for oil. Kadane's well was producing from the same formation and the same depth as Mrs. Clifton's well, the formation being known as the Atoka Conglomerate found at a depth from 5,300 to 5,600 feet. Under Texas Railroad Commission Regulations the drilling of a second gas well into the same horizon would not affect the allowable withdrawal and might result in actual harm to the lessor.

The basis of the suit was the charge that production in paying quantities from the existing well had ceased, and

[4] The Texas Court of Civil Appeals referred to the acreage thus: "The size of the lease is approximately equal to the basic size used by the Railroad Commission in computing the size of a reservoir."

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that Koontz *et al* had breached the implied covenants "to reasonably develop the existing minerals and/or to reasonably explore for the new sources of production." Damages for non-development were also sought, but the trial court held that they were incapable of being established with sufficient certainty to form the basis for a judgment. The trial court further found that the production of gas in paying quantities had not ceased and denied cancellation based on that premise.

The trial court found, however, that Koontz *et al* had breached the implied covenants "to reasonably develop and reasonably explore the lease for oil and/or gas," and conditionally granted forfeiture of the leasehold estate "except for the stratigraphic interval between 5,300 to 5,600 feet." With that exception the lease was ordered cancelled unless within sixty days the lessee drilled a new well to a depth of 5,600 feet.

The Court of Civil Appeals reversed this action of the trial court and proceeded to consider cross-assignments of error filed by Koontz *et al* in connection with which it held that the case should be considered as one involving exploration rather than development. It found that there was no evidence in the record of any geological formation or horizon in the area other than the Conglomerate, and that the record was lacking in evidence that a reasonably prudent operator would drill in the area and make search for oil in any other horizon, finding also that Mrs. Clifton impliedly admitted this to be true. It further found that Kadane would not be bound by the mentioned contract, because Koontz' lease was cancelled only as to horizons outside the Conglomerate, it being emphasized, that there was no proof of any other known formation in the area from which any production might reasonably be expected.

Considering the case from the standpoint of *development* the Appeals Court felt that, in the light of hindsight, it had been demonstrated that the existing well ought to have been reworked at an earlier date, but held that damages for the delay were not sufficiently proven. The court quoted with approval from an article by C. J. Meyers in

34 T. L. R. p. 553, 581, in which it was stated: "The covenant of further exploration need not become a lease breaking device and will not become one *if the courts exercise control over it.*" [Emphasis supplied.]

The Court of Appeals, declaring that "The trial court was clothed with great latitude of discretion in deciding whether the existing well on the lease had or had not 'ceased' to produce" oil and gas in paying quantities, held that the trial court's finding was supported by the evidence and concluded that, under the production limitations fixed by the Texas Railroad Commission, there was no showing of a breach of covenant on the part of the lessee.

Upon Mrs. Clifton's appeal to the Supreme Court of Texas, that court first considered whether "there was any evidence to sustain the finding of the trial court that production in paying quantities had not ceased." A good part of the opinion is taken up with a discussion of the meaning of the requirement for production in paying quantities and, after a detailed consideration, the Supreme Court found that the trial court was supported in its finding that there was such production. The opinion then deals at length with the question of whether the one well represented reasonable development of the lease and concludes that, in view of the regulations of the Railroad Commission as applied to the facts of that case, there was no violation of the implied covenant for reasonable development.[5]

The Supreme Court then treated briefly the question of further exploration, repudiating a decision of the Texas Court of Appeals in *Willingham v. Bryson*, 1956, 294

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[5] The ruling is epitomized in this statement from 325 S. W. 2d 695: "The field rules prescribed by the Railroad Commission . . . provide for 320-acre units with 10 per cent tolerance so that a maximum of 352 acres may be assigned. Consequently, on this particular 350 acre tract, only one well could be permitted to be drilled to the Morris sand. . . . Thus, it is seen that if a second well had been drilled on the 350-acre lease to the Morris sand, then the total allowable for the two wells would have been no greater than the allowable for one.

"We conclude from all of the above circumstances that the respondents did not violate the implied covenant to reasonably develop the lease by the drilling of additional wells. . . ."

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S. W. 2d 421. It approved the finding of the trial court that under the facts and the terms of the lease, there was no duty to conduct further exploration. In approving that finding the Supreme Court used quite general language, which Sinclair seizes upon as establishing the general rule of law it conceives to be controlling in the case before us, that a lessee is released from the duty of further exploration of a lease after production has been established on lands included in it.

This general language is, of course, limited to the facts before the court.[6] The Supreme Court of Texas was conscious of this rule of law and stated it in clear terms (325 S. W. 2d 696):

> "However, it should be noted that we do not have a factual situation where the lease covers several thousand acres and an effort is being made to hold such vast acreage by showing production from a comparatively small area. Neither are we confronted with a situation where an unreasonably long length of time has elapsed since the last development of the leased premises. Therefore, we do not pass upon these questions."

These words of caution could not have furnished a surer guide for interpretation of its language if they had been used with the case now before us in mind.

That the Supreme Court of Texas was not, in *Clifton* v. *Koontz*, announcing any radical departure from long

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[6] The Court of Civil Appeals of Texas, 1954, in Mitchell et al. v. Town of Refugio et al, 265 S. W. 2d 261, 267, referred, in stating this general rule, to 14 Am. Jur., p. 291, Courts, §79. The opening words of that section are these: "The language and general expressions in an opinion of the court are to be taken in connection with the case—that is, the facts and issues involved in the particular record under investigation in which those expressions are used. . . ."

The Supreme Court of the United States referred to the rule thus in Armour & Co. v. Wantock et al, 1944, 323 U. S. 126, 132-133: "It is timely again to remind counsel that words of our opinions are to be read in the light of the facts of the case under discussion." And see also Massachusetts v. United States, 1947, 333 U. S. 611, and Freeman, Trustee v. Hewit, Director, etc., 1946, 329 U. S. 249.

established principles of law is made further obvious by its citation of the landmark cases of *Brewster* v. *Lanyon*, 8 Cir., 1905, 140 F. 801, and *Sauder* v. *Mid-Continent Petroleum Corp.*, 1934, 292 U. S. 272, reversing the decision of the same case by the Circuit Court of Appeals for the Tenth Circuit, 1933, 67 F. 2d 9. These two decisions have been cited so generally that they are looked upon by many writers as the main foundation of modern oil and gas law establishing the duties of a lessee in an oil and gas lease and they deserve treatment at some length because of that fact.

Brewster v. *Lanyon*, written by Judge Van Devanter not long before he became a member of the Supreme Court, delved deep into the general nature of this lessor-lessee relationship, and some of the general principles enunciated in the decision are quoted in the margin.[7] These discon-

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[7] "Although the parties with sanction of a general practice, denominated the instrument a 'lease,' strictly speaking it was not such, but was more in the nature of a grant in praesenti of all of the oil and gas in the lands described—these minerals being part of the realty—with the right to enter and search for them, and to mine and remove them when found. . . . [p. 807]

"Looking, then, to the present lease, it is seen that the real object thereof was the oil and gas believed to be in or obtainable through the lessor's land, and the right to search for them and to reduce them to possession. . . . [p. 809] The implication necessarily arising from these provisions—the intention which they obviously reflect—is that if, at the end of the five year period prescribed for orginal exploration and development, oil and gas, one or both, had been found to exist in the demised premises in paying quantities, the work of exploration, development, and production should proceed with reasonable diligence for the common benefit of the parties, or the premises be surrendered to the lessor. That this was of the very essence of the contract is shown by the extensive character of the grant, which was without limit as to time and included all the oil and gas in or obtainable through the demised premises; by the provisions for the payment of substantial royalties in kind and in money on the oil produced and saved, and the gas used off the premises, which, as contrasted with the consideration paid when the lease was executed, shows that the promise of these royalties was the controlling inducement to the grant . . . Considering the migratory nature of oil and gas, and the danger of their being drawn off through wells on other lands if the field should become fully developed, all of which must have been in the minds

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nected excerpts from the *Brewster* opinion are set forth only as accurate and universally accepted declarations of the nature and general incidents and concomitants of an oil and gas lease as applied by the Supreme Court and the courts of the oil states.

The decision of the Supreme Court in *Mid-Continent Petroleum Co.* v. *Sauder et al., supra,* cited as aforesaid by the Texas Supreme Court in the *Clifton* case, bears such a close resemblance to the one before us now that a careful look at its facts and its holdings is indicated. A district court in Kansas had decreed cancellation of an oil and gas lease upon a half section of lands, saving to the lessee only the forty acres adjoining it on which two small producing wells had been drilled. By divided court, the Circuit Court of Appeals of the Tenth Circuit reversed on the ground of the overwhelming showing of geological information that oil would probably not be found under this 320

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of the parties, it is manifest that the terms of the lease contemplated action and diligence on the part of the lessee. . . . The subject was, therefore, rationally left to the implication, necessarily arising in the absence of express stipulation, that the further prosecution of the work should be along such lines as would be reasonably calculated to effectuate the controlling intention of the parties as manifested in the lease, which was to make the extraction of oil and gas from the premises of mutual advantage and profit. [p. 810]

". . . These provisions make it plain that it was the intention of the parties to make the covenants of the lessee conditions as well as covenants, and to reserve to the lessor the right to avoid the lease for the breach of any of them.

". . . The conclusion is that compliance with the covenant to continue with reasonable diligence the work of exploration, development, and production after the expiration of the five year period, if during that time oil and gas, one or both, be found in paying quantities, is by the terms employed made a condition the breach of which entitles the lessor to avoid the lease. . . . [p. 812-813] By reason of the conditions on which the lease is granted the lessor retains at least a contingent interest in the oil and gas, to the profitable extraction of which the operations are directed. . . . The object of the operations being to obtain a benefit or profit for both lessor and lessee, it seems obvious, in the absence of some stipulation to that effect, that neither is made the arbiter of the extent to which or the diligence with which the operations shall proceed, and that both are bound by the standard of what is reasonable. . . . [p. 814]

acres.[8] The Supreme Court granted certiorari and, as shown by the briefs 272 U. S. 273, Mid-Continent's contention was that under *Brewster* v. *Lanyon* and other cases, "its lease does not impose upon it any implied obligation to drill an additional well upon the leased premises, in the absence of an affirmative showing that, under all the circumstances, there was a reasonable probability that oil or gas, in paying quantities, would have been discovered, or that a reasonably prudent operator would have drilled. . . . The burden was upon the petitioners to plead and prove that some of these conditions existed."

Responding to that contention, the Supreme Court, by unanimous decision of the participating Justices, including the author of *Brewster* v. *Lanyon, supra,* commented on the fact that the two wells which had been drilled were offset wells, that seventeen years had expired since their drilling, that the district court, while finding that probably some damage was being done to the leasehold by wells on adjoining property, was unable to decide the question of the

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[8] Judge McDermott wrote a vigorous and well documented dissent, which is worthy of close study because his reasoning was adopted by the Supreme Court in preference to that of the majority. Some of the dissenting Judge's graphic language is worth repeating (67 F. 2d 16):

"If the phrase 'having regard for the interests of the lessor' has any real meaning, I think the defendant ought not to hold 320 acres, almost surrounded by oil wells, without even one test well. The defendant, in common fairness, ought to give these lessors a well or get off and let someone else drill it. . . .

"The truth is that this half section is neither proven nor condemned. No one will ever know whether there is oil under this land until a drill goes down. Mr. Moody [the lessee] says that; his geologists say it, their anxiety to keep it corroborates their statements. Mr. Moody wants some other company to drill on adjoining acreage; in other words, he wants to retain his gamble at the expense of his lessors and adjoining operators . . .

"But Mr. Moody . . . knows too much to release this lease because of geologic guess. Their science is valuable to condemn the lease in court in justification of a failure diligently to develop; but he will not back their testimony by relinquishing the lease. . . .

". . . I think a decree should enter that the lease as to the 320 acres be cancelled unless, within a reasonable time, an exploratory well is drilled to the Mississippi lime."

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likelihood that additional wells would produce oil or gas in paying quantities, which nothing but exploration by drilling could settle, and held that Mid-Continent had not in good faith and with reasonable diligence explored and developed the lands as required by the implied covenants of the lease. Adverting to the fact that the Circuit Court of Appeals had announced that "The question for decision is whether the respondent failed to comply with an implied covenant to develop the tract with reasonable diligence," the Supreme Court concluded that "the rule followed generally requires a reversal of the decree dismissing the bill." Here is some of its language which has been almost universally accepted and has been cited and quoted in numberless cases:

> "It is conceded that a covenant on respondent's part to continue the work of exploration, development and production is to be implied from the relation of the parties and the object of the lease . . . The petitioners say that if the lessee with good reason believes there is no mineral to be obtained by further drilling it should give up the lease; the respondent insists that as there is only a possibility of finding mineral, no prudent operator would presently develop, but the mere possibility entitles it to hold the lease, because it is producing oil from a portion of the area. We think the respondent's contention cannot be sustained . . . . [p. 279]

The court thereupon quoted with approval three paragraphs from *Brewster* v. *Lanyon* and added:

> "This definition of the scope of the implied covenant has been generally adopted in decisions of Federal and State Courts [citing many cases including one from Texas, Texas Company *v.* Ramsower, 7 S. W. 2d 872]. The facts demonstrate that the respondent has not complied with its obligations. It has held a half section for seventeen years without the drilling of an exploratory well, and claims

to be entitled to hold the lease for an indefinite period with no exploration unless some other operator brings in a producing well on adjoining lands, or fresh geological data come to light. The two producing wells are on the forty acres comprising the smaller of the adjacent areas embraced in the lease. The justification for the respondent's position is that the geologic data and the experience upon surrounding lands are both unfavorable to the discovery of oil or gas upon the east half of Section Sixteen (the 320 acre tract). The respondent's officers state that they desire to hold this tract because it may contain oil; but they assert that they have no present intention of drilling at any time in the near or remote future. This attitude does not comport with the obligation to prosecute development with due regard to the interests of the lessor. The production of oil on a small portion of the leased tract cannot justify the lessee's holding the balance indefinitely and depriving the lessor not only of the expected royalty from production pursuant to the lease, but of the privilege of making some other arrangement for availing himself of the mineral content of the land.

"The decisions on which the Circuit Court of Appeals relied recognize and apply the rule of Brewster *v.* Lanyon Zinc Co. supra, but are distinguishable because of a difference in the circumstances in which the rule was applied. . . . In none of them was there a neglect to explore or develop for any such period as is here shown, or an expressed intention not to do so, in a comparable situation." [pp. 280-281]

The court thereupon announced that the decree suggested by dissenting Judge McDermott, cancelling the lease as to the three hundred twenty acre tract unless within a reasonable time an exploratory well should be drilled, would recognize and protect the equities of both parties.

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The principles announced in the *Brewster* and *Sauder* cases have been applied uniformly by the Courts of Texas, e.g., *W. T. Waggoner Estate* v. *Sigler Oil Co.*, S. Ct. of Tex. 1929, 19 S. W. 2d 27; *Lido Oil Co.* v. *Waggoner*, Tex. Ct. Civ. Ap. 1930, 31 S. W. 2d 154; and *Perkins* v. *Mitchell et al*, S. Ct. Tex. 1954, 268 S. W. 2d 907; and by this Court, *Cosden Oil Co.* v. *Scarborough*, 1932, 55 F. 2d 634; *Cowden* v. *Texas Development Co.*, 1937, 89 F. 2d 947; *Amerada Petroleum Co.* v. *Doering*, 1937, 93 F. 2d 540; *Hull* v. *Magnolia Petroleum Co.*, 1941, 119 F. 2d 123; *Humble Oil & Refining Co.* v. *Romero*, 1952, 194 F. 2d 383, and cases discussed *infra;* and by the Courts of Oklahoma and other states in which oil and gas are produced. We do not find any authorities cited by Sinclair, or its efforts to explain the foregoing decisions of this Court, or the *Brewster* and *Sauder* cases convincing or as justifying the basic conclusion which it seeks to establish: that exploration in any part of a lease, particularly where production ensues, nullifies the obligation to explore other parts of the lease. The *Clifton* case is a good example of the error in appellant's conception of the covenants for exploration and development. All that the Supreme Court of Texas did there was to affirm the findings of the trial court against the contention that the undeveloped 320 acres would probably produce oil, and that no profit to lessor or lessee would accompany the bringing in of other gas wells under the regulations of the Texas Railroad Commission.

None of the cases presented or discussed by Sinclair stand for the principle that under all circumstances exploration, accompanied or unaccompanied by production, of a portion of a lease, satisfies completely the implied covenants of exploration-development.

This Court said more than two decades ago:[9] "Necessarily each case depends for decision upon its own peculiar facts," and we have said the same thing in several more

[9] Cowden et al v. Texas Development Co., 1937, 89 F. 2d 947, 949.

cases.[10] We are of the opinion, therefore, that the facts of this case clearly distinguish it from the holding of the Texas Supreme Court in the *Clifton* case, and bring it clearly within the ambit of *Sauder* v. *Mid-Continent.* Of course, the facts in the case before us are much stronger in favor of the lessors in their insistence upon further exploration and development than were those in any of the cases cited or relied upon by either party.

We might add that even under the reversed decision of the Tenth Circuit in *Sauder,* there was sufficient evidence to sustain the finding of the lower court of the probability of oil discovery on other portions of the Masterson lands.[11]

The showing made by plaintiffs here was more than slight. Aside from the strong probative force of the oil shows encountered by Colorado and the producing wells drilled by Sinclair, the opinion evidence of plaintiffs' geologist Hughes was sufficient to support a finding of the reasonable probability of oil production on portions of the Masterson land. In the swearing match between him and Sinclair's expert Hornaday, Hughes had a little the better of the dispute by reason of his longer intimate acquaintance with the Panhandle territory. Hughes was of the opinion that the "submerged" mountain ranges underlying the Masterson land were in peaks and valleys, while Hornaday felt that there was only sloping table land. The trial judge was evidently more inclined to follow Hughes, and a reading of the testimony of both fails to convince us that he was wrong. This testimony, supported by the producing wells on portions of the Masterson land,

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[10] Amerada Petroleum Co. et al v. Doering et al, 1937, 93 F. 2d 540, 541; Hull et al v. Magnolia Petroleum Co. et al, 1941, 119 F. 2d 123; Humble Oil & Refining Co. v. Romero, 1952, 194 F. 2d 383.

[11] The majority there said (67 F. 2d 12): "In view of the long lapse of time since any development has taken place on the lease, the large area undeveloped, and the fact that the lessor is precluded from exploring it himself or through a third person, *slight indication* that the undeveloped portion contains oil or gas in paying quantities, regard for the interests of the lessee as well as the lessor, would require further development." [Emphasis supplied.]

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considered against the background of Sinclair's failure to use its own geologists as witnesses and to complete its seismographic tests, was sufficient to warrant a finding by the court below that exploration or development of portions of the Masterson land would probably prove profitable to the lessee as well as the lessor.

We think that Sinclair's argument that it is entitled to credit on its implied covenants of exploration and development for all of the wells drilled by Continental and its predecessors, is without merit. This is so as a matter of fact, because only a negligible percentage of wells drilled by the owner of the gas rights penetrated the horizon where the proof shows oil would be expected and where it has actually been found. The operator of the gas rights, from the standpoint of what actually happened and of logic, was diligent to avoid getting into any liquids whether oil or water, because of the difficulties in walling them off so as to prevent interference with the production of gas.

We think that the position is untenable also as a matter of law. Sinclair relies on our case of *Southern Minerals Corporation* v. *Simmons,* 1940, 111 F. 2d 333, as its authority. That case does not, in our opinion, stand for Sinclair's argument at all. The landowner there was in no way involved in the litigation. The contest was between the original lessee, holder of the oil rights, and its transferee, owner of the gas rights, under an agreement which provided that if either should bring in the other's product, he would not have to plug the well and lose his drilling costs, but would be permitted to complete the well, granting to the other the option to pay the costs and take it over. No question was there presented as to whether exploration under the gas lease inured to the benefit of the owner of the oil rights. The holding was that the working agreement between the owner of the oil rights and the owner of the gas rights was part and parcel of the separation of the two categories of rights, and was to be and remain mutual so that subsequent assignees might avail themselves of its benefits. The obligations to the lessor of the separate owners of oil and gas rights were not discussed.

Nor do we think that the arrangements between Sinclair and its predecessors on the one side and Colorado and its predecessors on the other have any effect on the claims of the Mastersons here. They are entirely *res inter alios acta.* Moreover, the lessors were not in any way involved in or affected by the agreements between these lessees.

We thing also that this contention of Sinclair is ruled against it by our recent case of *Mattison et al* v. *Trotti,* 1959, 262 F. 2d 339. This case involved Texas oil interests, the decision was written by a Texas Judge of long experience and great learning, and the holding, amply supported by the cited authorities, was that the will drilled by a lessee owning an undivided leasehold interest in land did not suffice to satisfy the obligation of the owner of another such interest so as to rescue a non-drilling leaseholder from forfeiture of his rights. We stated there that any other holding would be contrary "to the uniform holding of the Texas decisions that in an oil and gas lease, where there is no cash consideration paid, the drilling for and the production of oil or gas by the lessee is the prime consideration, and if not so stated in the lease will be read into it." We made it clear that responsibility in such matters is single. We were there construing the clause universally found in leases that they shall remain in force "as long . . . as oil or gas, or either of them, is produced from such land." In that case, the quoted words were not followed by the phrase "by the lessee," while that phrase does appear in all of the leases before us except one. This contention is, therefore, clearly disposed of by the language of the leases themselves and the holding of the case discussed.

As to three of the leases embracing nearly half of the lands involved in this action, Sinclair takes the position that the inclusion of express covenants to drill for oil or

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gas within a specified time has the effect of excluding any implied covenants for exploration, development and production. The first of the leases to which this argument is directed is one dated May 10, 1923 covering 29,455.11 acres executed to Producers and Refiners Corporation at a consideration of $1.00 per acre. The lease carries a ten year primary term and provides for a rental of $1.00 per acre for that period.

The lease requires the lessee to begin exploration within six months and to follow it with a second well within ninety days thereafter. The lands covered by this lease embrace most of those in the northeast and northwest corners of the Masterson land, as well as another large body of land near the southwest corner and other separated parcels in other portions. Shortly prior to the expiration of the primary term, the then owners of the lease, Canadian River Gas Company, owner of the gas rights, and Parcomis Oil and Gas Company, owner of the oil rights, agreed to continue the payment of the $1.00 per acre annual rentals to lessor until and unless royalty payments under the lease should exceed the rental payments due.

The second of the leases embraced in this contention, executed May 7, 1926, also contained a special obligation to drill two wells to a certain depth within a specified time; and the third such lease, dated June 1, 1926, likewise expressly required two wells to be drilled to a certain depth within a specified time. All of the wells covered by these special agreements were drilled within the requisite time limits.

Sinclair contends, therefore, that each of these three leases covering respectively 29,455.11 acres, 5,712.85 acres, and 5,247.2 acres, demonstrates that the parties had the intent of declaring that two wells seeking oil on each of the leases would constitute reasonably adequate explora-

tion and development. The authority upon which it chiefly relies to sustain this contention is the case of *Gulf Production Co.* v. *Kishi* (Tex. Comm. App. 1937, adopted by the Supreme Court of Texas), 103 S.W. 2d 965.

Examination of that case reveals that it involves two leases, the first covering 150 acres with a recited consideration of $2,000.00, providing for the drilling of twelve wells in rapid succession with forfeiture attending failure so to drill, and with the provision that only five acres should be saved to the lessee around each producing well. The second lease covered twenty acres and was given for a bonus of $100 per acre and like provisions were inserted for the rapid completion of wells within a short time limit under pain of forfeiture.

The case quotes the general rule as to implied covenants from Merrill, Oil and Gas Leases, p. 968: "The implied covenant for further development is based by the courts upon the same foundation as that for exploration, namely that the inducement for the making of the lease is the lessor's desire to have his land promptly explored and thoroughly and diligently developed, and that, therefore, where the lease is silent upon the subject it is impliedly agreed that the lessee shall be diligent in developing the premises if oil and gas is discovered in paying quantities."

The Commission found under the facts above outlined that fifteen wells on one tract and six on the other constituted reasonable development and showed a clear intent of the parties to the leases that the drilling of the specified number of wells would constitute performance of the entire obligation of reasonable development. It is difficult to perceive how any reasonable person could have concluded otherwise than that twenty-one wells on 170 acres was indicative of an extreme measure of diligence.

That case and the other authorities relied upon do not, in our opinion, furnish authority in respect to the three leases before us. It would put a hard strain upon one's sense of proportion to assume that a landowner would be content with six wells on a little less than forty thousand acres. A reading of the three leases involved here

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convinces us that the parties had no such intention, but were merely speeding up the implied covenant of the lessees for reasonably diligent exploration and development by setting a deadline for at least two wells under each lease. Reverting again to the Producers and Refiners' lease, an examination of the map shows that this lease covers seventy-five tracts of land ranging from about eight acres to more than seven hundred acres, and that many of those tracts are as far apart as twenty miles. To assume that the parties intended that two wells on such a lease would constitute full performance by the lessee would be to give ear to the absurd. This contention is wholly devoid of merit and we do not find it supported either by reason, by the terms of the leases, or by any of the authorities upon which reliance is placed.

The next specification of error argued by Sinclair is that, as to the 18,500 acres embraced in a lease given by the Mastersons in 1916 to one Nobles, plaintiffs are estopped by a judgment rendered against them in a suit in the District Court of Potter County, Texas styled *R. B. Masterson* v. *Amarillo Oil Co. et al.*, which judgment was affirmed by the Court of Civil Appeals in 252 S. W. 908 (1923, writ dismissed). The present action was begun more than thirty years after that one was concluded. A lessee's obligation under an oil and gas lease is continuing and ambulatory.

The judgment rendered in the former suit cannot be construed as *res judicata* of the present action under general principles of law, and particularly since, in the former suit (253 S. W. 915-916), the appellate court specifically approved the limitation placed upon the judgment by the trial court that it should apply only to forfeiture and cancellation and should "not be a bar to any future action for damages or specific performance." The judgment now before us does not compel Sinclair to drill on the land covered by the Nobles lease, but gives it the right so to do. The reservation in the former decree leaves the court below full discretion to award damages or specific performance if the facts then presented should warrant. That is all the

Mastersons are seeking, and the former judgment stands as no impediment to the rendition by the court below of any judgment for damages or specific performance and the authorities cited by appellant do not, in our opinion, support its contention.

A further contention of Sinclair is that the fifteen wells drilled by it since this action was begun make it moot, absolving Sinclair from further obligation to explore or develop. No authorities are cited and reliance for justification of Sinclair's position is based largely on the testimony of its subordinate official Lowrance and its independent geologist Hornaday. The court below was not persuaded by these arguments; nor are we.

When this action was begun in June, 1955, no drilling had been done by Sinclair or its predecessors, owners of the oil rights, for more than twenty-five years. The court below had the power to adjudicate the rights of the parties as of the time the action was begun; but in the exercise of its equitable discretion it did not do so, but considered and gave weight to defendant's actions in the ensuing years. Prior to the filing of the action plaintiffs had endeavored to induce Sinclair to begin drilling activities, but it replied in writing that it was under no obligation to do so.

The fifteen wells drilled or "staked" for drilling in approximately two years are confined to two of the thirty-one leases. If that rate should be pursued, exploration and development would not be completed on the entire tract based upon Texas spacing laws under several centuries. The court below was not satisfied with the speed of the actions taken by Sinclair, and we think that the facts justify its displeasure. In order to stimulate the defendant to action at a tempo more in keeping with the vast areas to be explored the court suspended the hearing for many months, indicating by its letter to the litigants that it did not think the rate of development and exploration as followed by Sinclair was adequate. Even after that, Sinclair did not move any faster and the court had no alternative except to enter a judgment compelling it to do so.

That judgment is attacked by Sinclair as being arbitrary and unreasonable. We think quite the opposite is true.

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We find no reported case approaching this one in the magnitude of operations required and the slow pace of progress in the performance of contractual obligations.

Having before it thirty-one separate leases, each entitled to enforcement with respect to the implied covenants to explore, develop and produce,[12] the court chose not to lay that heavy a burden upon defendant, but to treat the entire 90,000 acres as if under one lease. It decreed forfeiture only in event Sinclair declined to carry out the program provided for the first year and granted full protection with respect to developed acreage. It did not, for the ensuing four years, *require* drilling, giving Sinclair the option to surrender, in lieu of drilling each well, 3,000 acres of the leasehold interest it had contended and proven to be worthless. For the five year period covered by the order the rate of drilling was set for one well for each 3,000 acres. The defendant had, for more than twenty-five years, held for a nominal consideration a gamble in which it had everything to gain and nothing to lose. Its leases stood as a cloud upon the title of the landowners and a complete deterrent to development by them or anyone else. Under the facts in this record we do not see how the court could have done other than to grant plaintiffs the relief they sought.

The judgment entered represents, in our opinion, the admixture of common sense with the vast knowledge of oil operations possessed by the trial court, and the program of exploration and development it set for Sinclair was characterized by unusual generosity. Contrary to defendant's contentions, the judgment rendered by the learned trial judge is, in our opinion, clear and unambiguous and the findings upon which it was based are fully justified by the evidence. The judgment is right and is

AFFIRMED.

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[12] Cf. Meacham *v.* Halley, Ct. Ap. 5 Cir. (Tex.) 1939, 103 F. 2d 967, 971; Mattison *v.* Trotti, *supra*, and 3 Summers Law of Oil and Gas, Par. 515, p. 441.

APPENDIX B

JUDGMENT.

Extract from the Minutes of October 27, 1959.

SINCLAIR OIL & GAS COMPANY,

No. 17530.

versus

R. B. MASTERSON, *et al.*

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed;

It is further ordered and adjudged that the appellant, Sinclair Oil & Gas Company, and the surety on the appeal bond herein, Federal Insurance Company, be condemned, in solido, to pay the costs of this cause in this Court for which execution may be issued out of the said District Court.

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APPENDIX C

ORDER DENYING REHEARING.

Extract from the Minutes of December 21, 1959.

SINCLAIR OIL & GAS COMPANY,

No. 17530.

versus

R. B. MASTERSON, *et al.*

It is ordered by the Court that the petition for rehearing filed in this cause be, and the same is hereby, denied.

Proof of Service.

I, NAT. J. HARBEN, Counsel of Record for Sinclair Oil & Gas Company, Petitioner herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the day of March, 1960 I served a copy of the foregoing Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit, on attorneys for R. B. Masterson, et al., Respondents, by mailing a copy airmail postage prepaid in an envelope addressed Culton, Morgan, Britain & White, attention Mr. D. H. Culton, P. O. Box 189, Amarillo, Texas.

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